Potential Clouds on the Horizon for Office Loans

lending industry update credit risk

Summary: The outlook for office loans is less than rosy. The US is set to have a glut of office space for a number of reasons, not the least of which is increased utilization of remote workers. For CFIs starting to experience stress in their office loan portfolio, we share several ways to mitigate potential problems.

A recent survey conducted by OnePoll revealed that far fewer Americans have actually travelled out of their home state, than previously thought — a whopping 16%, to be more precise. If you're a part of the 16%, then likely you didn't have an opportunity to explore different states or countries in your youth, a leading reason why some folks may have stayed home in their adulthood. Now, if you live in a major US city, there's a 60% chance that you're also working from home. Maybe you'll return to the office, maybe not, as work norms evolve after the worst of the pandemic.

Multiple yourself by millions of people and you get the current state of the commercial office space market. Leases on 243M square feet of office space totaling more than 10% of the US supply are scheduled to expire this year. Unused office space could flood the market, leaving both landlords and the CFIs who hold their loans in a pinch.

About half of banks have office commercial real estate loans on their books, taking up an average 5.6% of a bank's total loan portfolio. The CRE market is worth about $16T, of which office space makes up $3.2T. As we look into the near future, here are a few factors that will continue to limit the demand for of office space and potentially cause problem loans:

Vacancy rates let office occupants demand lower rents

At the beginning of 2020, the office vacancy rate was 9.6%. It rose to an average of 12.3% in the 1Q 2022. Lower occupancy rates give office tenants more bargaining power. They're more likely to ask for – and get – lower rents. The combination of lower rent from fewer total tenants could leave landlords in a tough financial spot, potentially decreasing their ability to pay back loans.

Real estate holdings could be trimmed

The federal consumer price index stood at 8.5% in March, and inflation has topped 6% for the six past months. That's pushed up the price of everything in corporate life, including labor, supplies and build-outs. Those higher costs make it less likely that firms will take on additional real estate costs and suggests that they will look at offices as a place to trim outlay if they can.

Russia-Ukraine war likely to temper economic growth

Many analysts expect that the American economy will expand this year, but high inflation and war between Russia and Ukraine will likely temper that expansion. Supply-chain problems, which the conflict exacerbates, and the possibility of new COVID variants and outbreaks are also potential brakes on economic growth.

Multiple factors suggest working from home will continue

It's certainly possible that more workers will return to corporate offices, especially if life-threatening cases of COVID-19 become increasingly rare. But other factors argue against the idea that employees will abandon home offices anytime soon.

Employees are betting their own money on work-from-home spaces

Perhaps the economic bets that employees are making tell us the most. Housing prices have risen by 30% since 2019. And get this: buyers' desire for more remote-working space was behind more than half of the 24% jump in prices that occurred between December 2019 and November 2021.

The pandemic forced companies into an experiment with remote work, and the results were mostly positive, with employees doing their jobs effectively from home. Many of those workers are reluctant to give back the time, comfort, and productivity they've gained — and that may have lasting effects on the CRE market.

What can you do?

If your institution is starting to experience stress in your office loans, here are several things you should consider:

1. **Revisit existing office loans.** If possible, renegotiate terms and conditions with borrowers, including requiring more personal guarantees in some cases. For stressed loans, increase workouts and provision more for potential nonperforming loans. Be sure to communicate to regulators how your institution is handling a stressed office loan portfolio.
2. **Diversify your loan portfolio.** Expand the types of CRE loans you make, as many categories like loans for apartments and industrial space – particularly for eCommerce distribution centers – are faring well. Also consider making more C&I loans and other types of loans as well, including niche loans for such items as luxury motor coaches, yachts and private jets.
3. **Find more sources of non-interest fee income.** Your institution can offer ancillary services to business owners like personal insurance or wealth management, as well as health savings accounts and retirement accounts for their employees. You may also want to consider forming partnerships with FinTech's that provide products and services through your institution via open banking and APIs – in which your institution can also earn fee income from the fintech.

The outlook for office loans over the next few years may look problematic, but your institution can find ways to mitigate that by being proactive with problem loans and diversifying both your loan portfolio and your other sources of income.

COMMERCIAL LOAN GROWTH AND FLOATING RATE ASSETS

ECONOMY & RATES

Rates As Of: 06/21/2022 10:03AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	1.63	0.47	1.57

6M	2.25	0.61	2.06
1Y	2.90	0.82	2.51
2Y	3.21	0.65	2.47
5Y	3.39	0.57	2.12
10Y	3.30	0.45	1.79
30Y	3.38	0.33	1.47

FF Market	FF Disc	IORB
1.58	1.75	1.65
SOFR	**Prime**	**OBFR**
1.45	4.75	1.57